Letter Ruling 02-7: LR 02-7: Reorganization with a QSUB and a Parent LLP

September 16, 2002

You have requested a letter ruling on behalf of ********** (“Taxpayer”). Your ruling concerns the income tax consequences of a reorganization that involves the creation of a limited liability partnership, the LLP’s election to be treated as an S Corporation, and the LLP’s direct and indirect ownership of various qualified S corporation subsidiaries, including the Taxpayer. This transaction is described in greater detail below.

I. Facts

The Taxpayer is a Delaware corporation with in-state offices. The Taxpayer owns 100% of the shares, directly or indirectly, of subsidiaries that own and operate restaurants, including bar and liquor service, in Massachusetts and other states. The Taxpayer acts as a holding company for these operating companies. The Taxpayer operates on a 52/53 week fiscal year. Through its fiscal year ended December 30, 2001, the Taxpayer has been taxed as a "C" corporation for federal and Massachusetts income tax purposes and has filed a federal consolidated and Massachusetts combined return, respectively.

Beginning in 2002, the Taxpayer has elected to be treated as a Subchapter S corporation for federal income tax purposes. The Taxpayer has also elected to treat each of its eligible subsidiaries (the “Subsidiaries”) as a QSUB as of the time of the S election.

II. Proposed Transaction

The Taxpayer and its shareholders (the “Shareholders”) propose to reorganize the company. The Shareholders will transfer all of their shares in the Taxpayer to a newly formed partnership and will cause the partnership to be registered as a Massachusetts limited liability partnership (the "LLP"). Subsequently, the Taxpayer will be wholly owned by the LLP. Interests in the LLP will represent each Shareholder's ownership in the business. After the transfer, the Shareholders will own interests in the LLP in the same proportion as they currently own shares in the Taxpayer.

Effective on the date of its formation, the LLP will elect for federal tax purposes to be treated as a corporation under the "check the box" regulation. *See* Treas. Reg. § 301.7701. The LLP will immediately elect to be treated as an S corporation effective with the date of its treatment as a corporation. Effective with the S election, the LLP will elect to treat the Taxpayer as a QSUB and will make elections or take other steps necessary to preserve the QSUB elections of each of the Subsidiaries.

Under the pertinent terms of the Massachusetts version of the Uniform Partnership Act, a partnership can register to become a limited liability partnership. *See* G.L. c. 108, § 45. The LLP will be formed under these provisions. The LLP will be governed by an agreement that provides, *inter alia*, that:

a. Transfers of interests are precluded unless the provisions of the Agreement are followed and partners holding a majority in interest in the LLP consent to the transfer.

b. Pursuant to the provisions of the Uniform Partnership Act, the LLP will terminate upon the occurrence of certain events including, but not limited to, the death or bankruptcy of a partner.

c. Only a partner (or group of partners) holding at least a twenty percent (20%) percentage interest in the LLP can assume the role of its manager.

You represent that pursuant to Treas. Reg. § 301.7701-2, as in effect prior to January 1, 1997, the LLP would be classified as a partnership since it would lack the corporate characteristics of centralized management, continuity of life, and free transferability of interests as defined therein.[1] Further, you represent that for federal tax purposes the proposed transaction will result in a tax-free reorganization pursuant to Internal Revenue Code ("Code") § 368(a)(1)(F).[2]

III. Rulings Requested

The Taxpayer requests the following rulings:

1. The LLP will not be treated as a corporate trust within the meaning of G.L. c. 62, § 1(j), but rather will be treated as a partnership within the meaning of G.L. c. 62, § 17.

2. All items of income, gain, loss, deduction, and credit of the Taxpayer and the Subsidiaries will be treated as those of the LLP.

3. The LLP's resident partners will be entitled to claim the credit allowed by G.L. c. 62, § 6(a) for taxes paid to other states and the District of Columbia by the partners, the LLP, the Taxpayer, or the Subsidiaries on account of income earned by the LLP, the Taxpayer, and the Subsidiaries.

4. Neither the Taxpayer nor the Subsidiaries will be subject to the net income measure of the corporate excise imposed under G.L. c. 63, §§ 32 and 39, nor to the entity level income tax imposed under G.L. c. 63, § 32D.

5. The Taxpayer and the Subsidiaries with taxable nexus in Massachusetts will be subject to the greater of the non-income measure of the corporate excise or the minimum corporate excise imposed under G.L. c. 63, §§ 32 and 39.

6. The LLP, the Taxpayer and the Subsidiaries will recognize gain or loss as a result of the formation of the LLP and the elections to be treated as an S corporation and QSUBs only to the extent recognized for federal income tax purposes.

IV. Discussion

In essence, your inquiry comprises questions concerning the LLP, the Taxpayer and the Subsidiaries, and the reorganization of the various entities. We address each of these issues in turn.

a. The LLP

The LLP is a partnership that has elected to be treated as a limited liability partnership pursuant to the Massachusetts version of the Uniform Partnership Act. *See* G.L. c. 108A, § 45. The term partnership is not defined for Massachusetts tax purposes. *See* G.L. c. 62, § 17. In general, a Massachusetts partnership and its partners are subject to the pass-through rules of G.L. c. 62, § 17 unless the entity is a corporate trust that is subject to the provisions of G.L. c. 62, § 8. *See* LR 99-13. A corporate trust is "any partnership, association or trust, the beneficial interest of which is represented by transferable shares." G.L. c. 62, § 1(j).

In this case, shares in the LLP cannot be conveyed unless partners that hold a majority interest in the LLP consent to the transfer. Under these circumstances the LLP cannot be characterized as a trust “with transferable shares.” *See* LR 01-07 (limited partnership is not taxed as a corporate trust where a partner's transfer of its interest is conditioned on the approval of the general partner). *See also* LR 99-13.

Further, a domestic partnership that elects to be treated as a corporation for federal income tax purposes is nonetheless treated as a partnership for Massachusetts tax purposes. *See* LR 99-13. A domestic partnership cannot be classified as a domestic corporation under the Massachusetts tax statute because it does not fit the definition of that latter term. *See* G.L. c. 63, § 30(1). Consequently, although the LLP has elected to be treated as a corporation for federal income tax purposes and has elected federal S corporation status, it will nonetheless be treated as a partnership for Massachusetts tax purposes. *See* LR 01-1.

A partnership as an entity is not subject to income taxation in Massachusetts. Instead, each partner includes in its taxable income its respective distributive share of the partnership's income, loss, credits, and other partnership items. *See* G.L. c. 62, § 17.

b. The Taxpayer and the Subsidiaries

The Taxpayer and the Subsidiaries are all corporations formed under the laws of the various states. For federal tax purposes, the Taxpayer has elected to be treated as an S corporation and to treat the Subsidiaries as QSUBs. Subsequent to the proposed transaction, the Taxpayer would itself be treated as a QSUB.

Under the General Laws, domestic corporations are subject to the excise imposed by c. 63, § 32 and foreign corporations are subject to the excise imposed by c. 62, § 39. In either case, the excise is comprised of several components, *i.e*., a minimum corporate excise; a property measure consisting of two alternative amounts, a tangible property amount or a net worth amount; and a net income measure. *See* G.L. c. 62, §§ 32, 39. The corporate excise is expressed as the minimum corporate excise or the combined property measure and net income measure, whichever is greater. *Id*. In addition, S corporations with gross receipts in excess of $6 million are subject to the income tax provisions set forth in G.L. c. 63, § 32D. “Net income”, as that term is used in G.L. c. 63, §§ 32, 39 and 32D is "gross income less the deductions, but not credits, allowable under the provisions of the Federal Internal Revenue Code, as amended and in effect for the taxable year." *See* G.L. c. 63, § 30.4.

Under Internal Revenue Code (“Code”) § 1361, federal S corporations are allowed to own QSUBs. A "QSUB," as that term is used in Code § 1361, means any U.S. corporation that can qualify as an S corporation and is 100% owned by an S corporation parent that elects to treat it as a QSUB. *See* IRC § 1361(b)(3)(B). Federally, a QSUB is not treated as a separate corporation. *See* IRC § 1361(b)(3)(A)(i). Rather, all assets, liabilities, items of income, deduction, and credit of the QSUB are treated as belonging to its S corporation parent. *See* IRC § 1361(b)(3)(A)(ii).

For purposes of Massachusetts tax law, a QSUB is a separate corporation that is subject to the greater of the minimum excise or the property measure. *See* TIR 97-6. However, because a QSUB has no items of income, etc., for purposes of the Code, a QSUB is not taxable pursuant to the income measure of the corporate excise, G.L. c. 63, §§ 32 and 39, or the entity-level tax imposed under G.L. c. 63, § 32D. Rather, as is also true under the Code, these income attributes pass-through to the parent of the QSUB. *See id.*

c. The Reorganization

The Taxpayer's proposed transaction involves the formation of the LLP and its "check-the-box" election to be treated as a corporation for federal income tax purposes, the contribution of the Taxpayer's shares to the LLP, and the subsequent elections to treat the LLP, the Taxpayer and the Subsidiaries as an S corporation or QSUB, respectively. In general, the proposed transaction raises tax questions concerning the implications of the contribution of the Taxpayer's shares to the LLP and the various federal tax elections.

The transfer of the Taxpayer's shares to the LLP will be treated as a tax-free contribution pursuant to Code § 351 because for federal purposes the LLP is treated as a corporation. Although the LLP is a partnership and not a corporation for Massachusetts income tax purposes, this same result would follow in the context of a partnership. *See* IRC § 721. Consequently, for Massachusetts tax purposes, the transfer of the Taxpayer's shares to the LLP will be treated as a tax-free contribution.[3]

As to the parties' various federal tax elections and the implications of these elections within the context of the proposed transaction, the analysis is more complex. You represent that the proposed transaction will constitute a non-taxable reorganization under Code § 368(a)(1)(f) (an "F reorganization"). Pursuant to the Code, an F reorganization is "a mere change in identity, form, or place of organization of *one corporation*, however effected." *See* IRC § 368(a)(1)(f) (emphasis added). There are at least two consequences of the proposed transaction that appear relevant for purposes of applying this provision. First, pursuant to its "check-the-box" election, the LLP will be treated as a corporation for federal tax purposes. Second, because the LLP will elect to be treated as an S corporation and elections will be made to treat the Taxpayer and its Subsidiaries as QSUBs, the LLP and the Taxpayer (including its Subsidiaries) will all be treated as a single corporation for federal tax purposes.

Previously, in Directive 00-9, the Department evaluated a similar reorganzation in which a parent entity was formed that was a corporate trust and not an LLP. *See* DD 00-9, Issue 1. In that Directive, the Department stated, with reference to the facts, that it would follow the federal non-recognition treatment accorded to an F reorganization when the parent entity is a corporate trust. *See id*. (evaluating the facts in a "Letter Ruling 99-17 type reorganization"). *See also* LR 99-17 (pertaining to a reorganization involving a QSUB and a parent entity that was a corporate trust). However, the Massachusetts statute that governs corporate trusts expressly states that such trusts are treated as corporations for purposes of the federal reorganization provisions. *See* G.L. c. 62, § 8(a) ("for purposes of any determination involving sections three hundred and fifty-one through three hundred and sixty eight of the Code any corporate trust shall be treated as a corporation*"). See also* DD 00-9, Issue 1 (relying on three rulings that followed the federal non-recognition treatment resulting from an F reorganization where the entiites in question were either a corporation or a corporate trust).

In this case, for Massachusetts tax purposes, the parent entity is not treated as a corporation as it is for federal tax purposes. Further, there is no prior authority in Massachusetts for the propostion that a partnership will be treated as a corporation for purposes of the state's recognition of a federal F reorganization. Nonetheless, for federal purposes, the proposed transaction will not trigger the recognition of any taxable gain to the parent LLP. Consequently, because the individual partners' Massachusetts income is computed by reference to federal gross income, we rule that there will not be any Massachusetts gross income on these specific facts. *See* G.L. c. 62, § 2. *See also* DD 00-9, Issue 1.[4]

V. Conclusions

On the facts you have presented, we rule as follows:

1. The LLP will not be treated as a corporate trust, but rather as a partnership subject to the provisions of G.L. c. 62, § 17.

2. All items of income, gain, loss, deduction, and credit of the Taxpayer and the Subsidiaries will be treated as those of the LLP.

3. The LLP will not be subject to taxes imposed by G.L. c. 62. The LLP's partners should report the LLP's various pass-through income items. For purposes of this reporting the various income tax items of the Taxpayer and the QSUBs will be treated as those of the LLP. The LLP's resident partners will be entitled to claim the credit allowed by G.L. c. 62, § 6(a) for taxes paid to other states and the District of Columbia by the partners, the LLP, the Taxpayer and its Subsidiaries on account of income earned by the LLP, the Taxpayer and its Subsidiaries.

4. Neither the Taxpayer nor the Subsidiaries, all QSUBs, are subject to the net income measure of the corporate excise, G.L. c. 63, §§ 32 and 39, nor the S corporation entity-level tax, G.L. c. 63, § 32D, because net income for purposes of these provisions is determined by reference to the Code, and a QSUB has no gross income under the Code.

5. The Taxpayer and the Subsidiaries doing business in Massachusetts will be subject to the greater of the property measure of the corporate excise or the minimum corporate excise. *See* G.L. c. 63, §§ 32, 39. Accordingly, if the proposed transaction takes place as stated then the Taxpayer and its Subsidiaries doing business in Massachusetts must file a corporate excise return to report the greater of: (1) any corporate excise attributable to its taxable tangible personal property or taxable net worth, or (2) the minimum corporate excise. *See id.*

6. The LLP, the Taxpayer and the Subsidiaries will recognize gain or loss as a result of the formation of the LLP and the elections to be treated as an S corporation and QSUB only to the extent recognized for federal income tax purposes. However, we note that in any instance where the Shareholders recognize federal gross income in connection with a liquidation of the LLP or a distribution by the LLP, the Shareholders will be likewise subject to Massachusetts tax.

Very truly yours,

/s/Sheila T. LeBlanc

Sheila T. LeBlanc
Senior Deputy Commissioner of Revenue

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[1] Under this federal regulation, which pre-dates the check-the-box rules, an entity lacking at least two of the following four corporate attributes would be classified as a partnership: centralized management, continuity of life, free transferability of interests, and limited liability. *See* Treas. Reg. § 301.7701-2 (1997).

[2] In particular, this representation is that the Taxpayer will seek an opininon from its tax adviser that the proposed transaction will be treated as a tax-free reorganization under IRC § 368(a)(1)(F) and that, absent this representation, the Taxpayer will not undertake the proposed transaction.

[3] We note that this analysis is further substantiated in this context by the analysis as to the

taxpayer's "F Reorganization", which follows in the text.

[4] Although the proposed transaction will not result in any federal gross income or consequent Massachusett net income, we note that there may be federal gross income in the instance in which the LLP liquidates or distributes appreciated property to the Shareholders. In either of these latter two instances, the Shareholders will be subject to Massachusetts tax in connection with the transaction.